clusions of law, and opinion of the District Court (R. 7–29), are not reported.

Huss, No. 305: The opinions of the Court of Appeals affirming the decision of the District Court (R. 67–70), and denying rehearing (R. 81–85), are reported at 255 F. 2d 599. The findings of fact, conclusions of law, and opinion of the District Court (R. 27–48) are reported at 150 F. Supp. 224.

JURISDICTION

The judgments of the Court of Appeals were entered on March 27, 1958 (No. 218, R. 39–41; No. 305, R. 70–72), and timely petitions for rehearing were denied on May 29, 1958 (No. 218, R. 47; No. 305, R. 85). The petitions for writs of certiorari were filed on July 25, 1958 in No. 218, and on August 25, 1958 in No. 305, and were granted on October 13, 1958 (No. 218, R. 48; No. 305, R. 86). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

The taxpayers are members of partnerships which, under contracts with the owners of coal lands, strip mined coal for delivery to the owners of the land and received therefor a fixed price per ton of coal extracted and delivered. The contracts had no fixed term, and were terminable at any time by the owners without cause merely by giving minimal notice to the stripper. The question presented is whether the taxpayers are entitled to percentage depletion deductions under Sections 23(m) and 114(b)(4) of the Internal Revenue Code of 1939 on the amounts re-

ceived during the taxable years for their strip mining operations.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of Sections 23(m) and 114(b)(4) of the Internal Revenue Code of 1939 and of Section 29.23(a)–1 of Treasury Regulations 111 are set forth in the Appendix, *infra*, pp. 41–44.

STATEMENT

In these cases, individual partners filed suits in the District Court for refund of income taxes paid upon their respective distributive shares of partnership income derived from strip mining operations,[1] on the ground that the partnership was entitled to a depletion allowance thereon. After trial, the District Court held that the partnerships did not have the requisite economic interest in the coal in place to justify depletion. The Court of Appeals affirmed, one judge dissenting from the denial of rehearing.

THE FACTS

The pertinent facts in each case, as found by the District Court and not here challenged, are as follows:

Parsons, No. 218. This case involves the taxable years 1945 through 1949, during which the partner-

[1] Strip mining is a method of extracting coal which is relatively near the surface of the land. Instead of sinking shafts and building tunnels therefrom, as is the practice in deep mining, the surface earth and rock which cover the coal is stripped off, and the uncovered coal is then removed. See G.C.M. 26290, 1950–1 Cum. Bull. 42, 43. See, also, the description of strip mining at pages 7–8 of the Schumacher Estate *amicus curiae* brief.

ship ("Parsons") strip mined coal on the property of Rockhill Coal Company ("Rockhill") (Fdgs. 5–7, 10, R. 8–11). Prior to 1943, Parsons was primarily engaged in road and highway building, and also did some strip mining (Fdgs. 3, 9, R. 8, 11); it is presently engaged in coal stripping and drilling gas wells (Fdg. 9, R. 11).[2]

Beginning in 1939, Parsons strip mined coal on Rockhill property which it had leased (Fdg. 11, R. 11). Parsons was unable to sell the coal, however, because it was oxidized, but Rockhill ascertained that it could use the coal by mixing it with Rockhill's own deep mined coal (*ibid.*). Parsons then surrendered its lease and, in February 1941, entered into a written agreement with Rockhill under which Rockhill agreed to pay Parsons a stated price per ton of coal delivered (*ibid.*; Ex. P–1, not printed). Rockhill could terminate the agreement only if Parsons violated its obligations thereunder, or if the coal could not be satisfactorily mixed with Rockhill's other coal (Ex. P–1). Parsons finished stripping the tract in 1943 (Fdg. 11, R. 11).

In February, 1942, Rockhill approached Parsons with a view to entering into another contract for strip mining a different area of Rockhill's land (Fdg. 12, R. 11). At a meeting, the parties settled upon a particular area for future stripping operations, and agreed that a written agreement would be prepared by Rockhill and submitted to Parsons for signature

[2] There were three successive partnerships which carried on the business since 1939 (Fdg. 3, R. 8). We refer to them interchangeably as "Parsons."

(Fdg. 13, R. 13). Such an agreement was prepared and on several occasions was presented to Emory Parsons (who represented the partnership in the negotiations) (Fdg. 14, R. 12). However, he refused to sign it because he did not want to be bound to an agreement requiring stripping which would take a long time, "since, if an opportunity opened up, he wanted to go back to road building work" (Fdg. 15, R. 12).

Instead, Parsons proposed to mine the designated Rockhill property under a terminable oral arrangement similar to the written 1941 contract (Fdg. 16, R. 13). Such a verbal arrangement was made, but it was terminable by either party merely on 10-days' notice (Fdg. 17, R. 13–14). However, if Rockhill terminated the contract, Parsons could remove, and would be paid for, any coal which lay under the overburden which it previously had removed, even though that took more than 10 days (Fdg. 18, R. 14).

Rockhill paid Parsons a stated price for each ton of coal delivered to Rockhill's railroad cars (Fdg. 22, R. 15–16). This price "covered all the work incidental thereto," including prospecting and mining expenses, depreciation on Parsons' equipment, building of roads, and the cost of supplies, labor, dockage, building a tipple and picking and cleaning the coal (Fdg. 23, R. 17–18).[3] The price also reflected the risk of removing overburden and finding no coal; but this "was not likely to have occurred on the Rock-

[3] During the course of the agreement, Rockhill assumed the job of cleaning the coal, and the price was correspondingly reduced (Fdg. 23, R. 18).

496789—59——2

hill lands, known to have coal deposits therein" (Fdg. 22, n. 13, R. 16).[4] Although the agreement provided that changes in the price paid per ton would be made only to reflect increases in labor costs, Rockhill also granted increases to reflect higher material costs (Fdg. 22, R. 15–16).[5] The price was not to vary with changes in the market price of coal (Fdg. 22, n. 12, R. 15).

Parsons had no right to, and never did, sell any coal that it mined from Rockhill property, and could not receive payment in coal instead of money (Fdg. 21, R. 15). Rockhill had the right to sell all the coal (*ibid.*).

Merely by giving 10-days' notice to Parsons, Rockhill could have put another stripper on the area which theretofore had been assigned to Parsons (Fdg. 20, R. 15). Rockhill also reserved the right to hire other strip miners to mine areas not allocated to Parsons (*ibid.*).

The areas in which Parsons was to work were allocated by Rockhill's engineering department, which had conducted preliminary surveys (Fdg. 25, R. 18–19). Parsons had discretion to determine the amount of equipment and the number of workers it would use on the allocated areas, as well as the quantity of coal

[4] All of the Rockhill property previously had been completely drilled and tested, and some of it previously had been deep mined (Fdg. 25, R. 19).

[5] On one occasion, Rockhill granted an increase when Parsons threatened to quit because it thought it could make more money by leasing out its equipment, conditioned on Parsons' building a road and opening an additional tract (Fdg. 22, n. 16, R. 16–17).

to be stripped (Fdg. 19, R. 14). However, if Parsons stripped coal at such a rate that Rockhill could not get enough deep mined coal to blend with the stripped coal, Rockhill did not have to accept the coal Parsons stripped but would have had to terminate the oral arrangement under the 10-day clause (Fdg. 19, R. 14–15). "In this manner, Rockhill controlled the quantity and quality of coal that Parsons stripped" (Fdg. 19, R. 15).

The approximate value of its equipment used by Parsons on Rockhill's property ranged from $60,000 in 1943 to $210,000 in 1946 (Fdg. 31, R. 21–22). In 1946 Rockhill began putting in its own equipment for Parsons to use, and Parsons removed some of its own equipment from the Rockhill property (*ibid.*). When Parsons stopped stripping on Rockhill property in 1950, it had there equipment worth only $125,000 (Fdg. 31, R. 22).

Parsons strip mined coal under the 1942 oral agreement until September 1950 (Fdg. 27, R. 19). On August 1, 1950, it gave Rockhill 30-days' notice that it was quitting (Fdg. 36, R. 24). However, it continued until September 5 to strip and load the coal that had been cleared of overburden (*ibid.*). After leaving Rockhill, Parsons began in the same month to strip for another company, under a lease arrangement (Fdg. 37, R. 24).

Parsons did not consider itself bound to mine the Rockhill properties to exhaustion (Fdg. 30, R. 21). When it ceased to work for Rockhill in 1950, strippable coal remained on the property (*ibid.*). Another

company continued to strip the area where Parsons had been working (*ibid.*).

Depletion was never mentioned by either of the parties to the 1942 oral arrangement (Fdg. 38, R. 24). During the time Parsons was working for Rockhill, it never requested its attorney to make an agreement under which it would have been assured of a depletion allowance (Fdg. 38, n. 37, R. 24–25). However, under the written contract which Parsons entered into with another company after leaving Rockhill (see *supra*, p. 7), it receives percentage depletion (*ibid.*). During the taxable years involved, Rockhill took the depletion deduction on the operations performed by Parsons on Rockhill land (Fdg. 39, R. 25). The Parsons' partnership tax returns did not claim depletion deductions on income earned from the Rockhill operations, although, during the same years, Parsons claimed depletion deductions on income from other property (*ibid.*).

Huss, No. 305. During the taxable years involved in this case (1944 to 1947, Fdg. 9, R. 29–30), the taxpayers were members of a partnership ("Huss") engaged in the business of strip mining coal (Fdg. 1, R. 27–28). Huss worked on land owned by the Philadelphia and Reading Coal & Iron Company ("Reading") under six written agreements with the latter (Fdg. 2, R. 28).* Five of these contracts covered a

*During the years 1944 through 1947, Huss also did strip mining for other persons, including the Stevens Company, for which it worked under periodic oral contracts (Fdgs. 4, 5, R. 28). The District Court held that Huss was entitled to depletion for income received under these contracts for the years 1945 through 1947, but not for 1944 (R. 43–47). The issue

contiguous tract (Tower City) (*ibid.*); the sixth covered an area a few miles away (Fdg. 3, R. 28).

Prior to signing the first agreement on May 27, 1944, Huss looked over the ground and moved in equipment in order to test for the presence of sufficient coal to begin strip mining (Fdg. 10, R. 30). In addition, before the five contracts covering the Tower City tract were executed, Reading furnished Huss with surface maps showing where the veins of coal were or were supposed to be (Fdg. 11, R. 30). The entire area covered by these contracts had been deep mined and the area covered by one of them had been partially strip mined, but Huss was the first to strip mine the areas covered by the other four contracts (*ibid.*). After the first contract was executed, Huss never investigated, by prospecting or test boring, before signing the other agreements (Fdg. 12, R. 30). It could see where the land previously had been mined and could ascertain the thickness of exposed veins of coal (*ibid.*).

Huss' job consisted of removing overburden from the top, drilling and shooting rock overburden, removing this overburden by means of a dragline, cleaning the coal, loading it on trucks and delivering it to the colliery (Fdg. 13, R. 30). Reading had the right, which it occasionally exercised, to place inspectors on the property to direct Huss as to the average amount of overburden to be removed in ratio to the coal (Fdg.

---

with respect to 1944 was appealed, and the Court of Appeals affirmed that ruling (R. 69–70). The correctness of the ruling denying Huss depletion under the 1944 Stevens agreement apparently is not here challenged.

14, R. 31). The inspectors also checked the coal before it was loaded to determine whether it was acceptable (*ibid.*).

Under the contracts, Huss was paid a stated price for each ton of coal delivered to the colliery. All the contracts provided (Fdg. 16, R. 31; see R. 104, 105) that this price was:

> full compensation for the full performance of all work and for the furnishing of all material, labor, power, tools, machinery, implements and equipment required for the work * * *; also, for all loss or expense incurred for delays caused by damage to the work or materials or otherwise; also for all loss, damage or expense arising in the progress of the work from unforeseen obstructions or difficulties or other risks connected therewith * * *.

The contract prices were fixed after considering, among other things, the amount of overburden to be removed to obtain a ton of coal, the possibility of recoverable coal in the tract, and the length of the haul from the tract to the point of delivery (Fdg. 25, R. 33). Negotiations as to contract prices were conducted on Reading's behalf by its engineer in charge of stripping in the area (Fdg. 26, R. 33). His recommendations with respect to a suggested contract price were based on a company study estimating the future market price of coal, the fixed costs, and an amount designed to insure a reasonable margin of profit (*ibid.*).

The contracts provided for an increase or decrease in the price paid corresponding to a change in labor

costs (Fdg. 27, R. 34). Except when labor costs changed, Huss was paid the same price per ton of coal without regard to whether or not Reading sold the coal, the price at which it did so, and the market price of coal (Fdg. 28, R. 34).

The coal did not belong to Huss, which had no right to sell it even if Reading rejected it (Fdg. 29, R. 34). If Reading agreed, Huss could negotiate a sale of coal to another colliery, but the sale would be on Reading's behalf; Reading would collect the purchase price, and Huss would receive only the per ton price stated in its contract (*ibid.*).

The contracts required Huss to strip mine coal as long as no more than a specified ratio of cubic yards of overburden per gross ton of raw coal recovered was present (Fdg. 24, R. 33). When this ratio was exceeded, mining would usually be unprofitable, and Huss was not required to mine (*ibid.*). However, if Huss thought the contract price warranted its doing so, it could continue to work after the stated ratio had been reached, and on occasion did so (*ibid.*). The contract, however, did not specify any fixed duration (Fdg. 31, R. 35).

Reading, in its discretion, could cancel and terminate the contracts prior to the completion of stripping merely by giving Huss 30-days' written notice (Fdg. 30, R. 34).[7] It could also suspend operations under

[7] See *e.g.*, Article 23, under which Huss agreed that Reading "shall have the right to entirely cancel and terminate this contract, without specifying any reason therefor, upon thirty (30) days' notice in writing * * *" (R. 139). One of the contracts (P-22) permitted immediate cancellation (R. 98-99).

the contracts for not more than five weeks; if the suspension continued for a longer period, Huss could then cancel the agreement (R. 98–99, 139–140).

Huss determined when and where to begin and to stop mining in a particular area, and whether it would be profitable to begin to mine (Fdg. 17, R. 31). However, Huss was not paid for prospecting costs covering an area which it decided not to mine (*ibid.*).

In order to get equipment to the first job site, Huss spent $10,000 to $15,000 (which included the cost of its own employees) for building roads and moving equipment (Fdg. 19, R. 31). Two shovels were moved 3½ and 1½ miles, respectively, under their own power (Fdg. 19, R. 31–32). The other Tower City areas were contiguous and, except for some equipment which was purchased, Huss moved equipment from one tract to another (Fdg. 19, R. 32). No equipment was permanently affixed to any of the tracts and all could be removed (*ibid.*). The trucks and bulldozers used were suitable for work other than coal stripping, although other equipment was not (*ibid.*).

About $100,000 worth of equipment, which was not acquired solely for the Reading job, was used initially on the Tower City tract (Fdg. 21, R. 32). By the end of 1947, Huss had about $500,000 worth of equipment on the job, but the same equipment (except for one machine) had been used on stripping contracts for other persons (*ibid.*). At the end of 1947, when Huss ceased stripping these tracts, all of its equipment used thereon was either moved to other properties, or was sold (Fdg. 20, R. 32).

Huss paid for all of the equipment, supplies, labor and materials used on the Reading job (Fdgs. 18, 22, R. 31, 32). However, it took deductions on its tax returns for all of those items as ordinary and necessary business expenses, and also received depreciation deductions on that equipment (Fdg. 22, R. 32).

After about three weeks of stripping, Huss was producing some tonnage from the area covered by the first contract, but about two months passed before it got sufficient tonnage to show a small profit (Fdg. 23, R. 33).

Huss continued to strip mine under the contracts until the stipulated ratio of overburden to coal was reached, at which point operations became unprofitable (Fdg. 31, R. 35). The contracts were then cancelled by mutual agreement (*ibid.*). Reading never exercised its right to terminate or suspend operations (*ibid.*).

THE DECISIONS OF THE COURTS BELOW

In each case, the District Court held (No. 218, R. 29; No. 305, R. 47) that the taxpayers, in conducting their respective stripping operations for Rockhill and Reading, "did not acquire an economic interest in the coal in place, entitling them to the depletion allowance on their gross income derived therefrom * * *." The two cases were considered at the same time on appeal and the Court of Appeals, in affirming, wrote its principal opinion in *Parsons*.

It there ruled (No. 218, R. 34), in an opinion by Judge Hastie, that although "the economic interest in coal in place which will support a percentage depletion

allowance for strip mining need not amount to an estate or tenancy as understood in the law of real property * * * it must be something more than an independent contractor's normal right to the benefit of his bargain and the kind of 'interest' which that right always gives him in the subject matter of the contract." After reviewing the "unchallenged" "facts found by the district court" (R. 35), it concluded (R. 36) that "what the parties agreed and what they did disclose the partnership act[ed] only as an ordinary independent contractor in mining the Rockhill tract." It emphasized two facts: (1) that the partnership could not sell or dispose of the coal itself, but was entitled only to the stated price from Rockhill, which did not fluctuate with the market; and that there was "no significant difference" in the terms "for payment to the partnership for its work" from "the normal payment to an independent contractor for accomplishing an agreed result"; (2) that the partnership had no right to, and did not, mine the tract to exhaustion; that the "terminability of the agreement on short notice was an essential and significant part of the bargain"; and that "the partnership contemplated and bargained for no economic interest in the mineral it agreed to extract beyond the independent contractor's normal concern with any subject matter with which he is to work for an agreed price" (R. 36–37). The court also stated (R. 39) that it is "very doubtful whether investment in equipment of general utility in a contractor's business [the only kind of investment which Parsons made in the Rockhill job] is the type of capital expenditure which can properly be found

to constitute an investment in a particular mineral deposit which the contractor has undertaken to work."

In its opinion in *Huss*, the court stated (No. 305, R. 68) that none of the compensation arrangements "suggest[s] that the stripper acquired an interest in the mineral in place"; that the trial court had not erred in viewing the coal company's "absolute right of termination on thirty days' notice as more significant than the fact that this privilege was not exercised in the given case" (R. 69); and that "[n]othing appears which distinguishes" Parsons' commitment of "about $500,000 worth of equipment to this job" "from capital expenditures normally made by independent contractors who undertake large projects in such familiar fields as road building and general construction" (*ibid.*).

SUMMARY OF ARGUMENT

Sections 23(m) and 114(b)(4) of the Internal Revenue Code of 1939 permit, as a deduction from gross income, "a reasonable allowance for depletion" which, in the case of coal mines, is limited to five percent of "gross income from [mining]." "A taxpayer is entitled to depletion where he has: (1) 'acquired, by investment, any interest in the [coal] in place,' and (2) secured by legal relationship 'income derived from the extraction of the [coal], to which he must look for a return of his capital.'" *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 314.

In these cases, the taxpayers entered into agreements with the owners of coal lands under which, in return for a fixed price per ton of coal delivered to the owner, they conducted strip mining operations on

the property, *i.e.*, they stripped off the earth and rock which covered coal near the surface, and then removed it. Since, if they had an interest acquired by investment in the coal in place, they would have had to look to income derived from its extraction for their return of capital, the second criterion for depletion would here be satisfied. The narrow question, therefore, is whether, by their contractual arrangements with the mine owners to conduct strip mining operations, the taxpayers "acquired, by investment, any interest in the [coal] in place."

A. Contrary to petitioners' contention, the depletion allowance is not intended to stimulate production of minerals and provide compensation for the risk therein. Its "fundamental purpose" is to provide "compensation to the owner for the part" of "wasting" "mineral deposits" which are "used up in production" (*Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 366); it is "designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired" (*Southwest Exploration* case, *supra*).

B. In order to be entitled to depletion, petitioners must establish that they had "a capital investment in the [coal] in place which is necessarily reduced as the [coal] is extracted" (*Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, 603). The requirement that the taxpayers have an "economic interest" (*Palmer* v. *Bender*, 287 U.S. 551, 558) in the mineral in place is not satisfied, however, through "a mere economic advantage derived from production,

through a contractual relation to the owner, by one who has no capital investment in the mineral deposit" (*Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 367). We submit that the Court of Appeals correctly held that the strippers were "acting only as an ordinary independent contractor in mining the [areas]" (No. 218, R. 36; see No. 305, R. 69); and that they, therefore, did not have any economic interest in the coal in place, but only a "mere economic advantage derived from production."

C. 1. One who contracts to perform services in connection with the extraction of minerals does not acquire an economic interest in the minerals in place merely because his compensation is based upon the volume of mineral extracted, or because he furnishes substantial equipment and supplies for the job. In order to obtain depletion, the arrangements between the parties must be such that the payments were not merely compensation for the performance of an employment contract, but represented a partial return of the stripper's capital investment in the mineral in place, which is being depleted by extraction.

We submit that a stripper can not have an economic interest in the coal in place where he does not have the right to remove a substantial and significant portion of that coal. That essential condition is absent here. In the instant cases, the strippers' contracts were terminable without cause by the mine owners on minimal notice. The taxpayers' right to extract coal, therefore, was in fact so tenuous as to be illusory. They were, by analogy to real

property law, only tenants at sufferance; they merely had employment contracts under which they could continue to work as long as the coal company was satisfied with their services.

It is well settled in other areas of tax law that the existence of an absolute right of termination may preclude the vesting of rights and obligations which might otherwise arise. Similarly, in the case of depletion, the existence of the right to terminate the strippers' rights without cause is completely inconsistent with the concept of an economic interest in the coal in place.

As long as the mine owners had the right to terminate without cause on short notice, it is immaterial whether the right ever was exercised. For in determining whether the strippers had the necessary interest in the coal in place, the crucial factor is what their rights were when the relationship was established.

2. But even if the coal owners' right to terminate without cause does not itself preclude an economic interest in the coal in place, it is difficult to see how the taxpayers made any capital contribution which would constitute the acquisition of such an interest "by investment" (*Southwest* case, *supra*). As the Court of Appeals pointed out (No. 305, R. 69), their capital outlays appear indistinguishable "from capital expenditures normally made by independent contractors who undertake large projects in such familiar fields as road

building and general construction." They could recover all of these expenditures through normal deductions for ordinary and necessary business expenses and depreciation. They had no right to keep or sell any part of the coal; their sole right was to remove it and turn it over to the coal companies in return for a stated price per ton. On their face, and in actual operation, the strip mining agreements were no more than ordinary employment contracts, by which the taxpayers strip mined coal under what, in effect, was a piecework method of compensation.

3. To the extent that the strip miner is allowed a depletion deduction, there must be a corresponding disallowance of the deduction to the owner of the property. The statutory provisions for depletion "must be read in the light of the requirement of apportionment of a single depletion allowance" (*Helvering* v. *Twin Bell Syndicate*, 293 U.S. 312, 321). A pertinent inquiry, therefore, is whether the mine owners, by their contractual arrangements with the strippers, fairly can be said to have given up a part of their ownership of the coal in the ground, so that a portion of their depletion allowance should be shifted to the contractors. We submit that the mine owners did not give up any part of their ownership interest in the coal by permitting the strippers to mine it pursuant to arrangements under which the owners retained the right to terminate the operation at will, and the strippers had no right to dispose of the coal for their own account.

ARGUMENT

TAXPAYERS ARE NOT ENTITLED TO PERCENTAGE DEPLETION DEDUCTIONS ON THEIR GROSS INCOME FROM STRIP MINING OPERATIONS

Sections 23(m) and 114(b)(4) of the Internal Revenue Code of 1939 (Appendix, *infra*, pp. 41–42) permit, as a deduction from gross income, "a reasonable allowance for depletion" which, in the case of coal mines, is limited to five percent "of the gross income from [mining]" during the taxable year. Under the principles governing the allowance of depletion in the extractive industries (developed by this Court in connection with the oil business), "a taxpayer is entitled to depletion where he has: (1) 'acquired, by investment, any interest in the [coal] in place,' and (2) secured by legal relationship 'income derived from the extraction of the [coal], to which he must look for a return of his capital.'" *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 314; *Palmer* v. *Bender*, 287 U.S. 551, 557–558.

In the instant cases, the taxpayers entered into arrangements with the owners of coal lands under which, in return for a fixed price per ton of coal delivered to the owner, they conducted strip mining operations on the property. Since their income from these operations depended solely on the amounts which they were to receive from the owners for the coal which they extracted, the second requirement for a depletion allowance would here be satisfied, namely, that any return of the taxpayers' capital must come from "income derived from the extraction" of the mineral.

The narrow issue in these cases, therefore, is whether, by their contractual arrangements with the mine owners to conduct strip mining operations, the taxpayers "acquired, by investment, any interest in the [coal] in place," Petitioners contend (*Parsons* Br. 12; see *Huss* Br. 10–11, Schumacher *amicus curiae* Br. 4, 18) that they acquired such an interest when they obtained the "right to mine" the coal "and be paid for it"; and that they made the necessary capital investment in the coal by committing their organization, equipment, and skill to the task of extracting it. "But the tax law deals in economic realities, not legal abstractions * * *." (*Southwest Exploration* case, *supra*, p. 315); and we submit that "closer analysis" (*ibid.*) of the relationship between the taxpayers and the owners of the coal lands shows, as the Court of Appeals held, that the taxpayers were "acting only as an ordinary independent contractor in mining the [areas]" (No. 218, R. 36; see No. 305, R. 69), and, therefore, did not acquire, by investment or otherwise, any interest in the coal in place.

Since this case involves the application to the mining industry of the depletion principles developed in the oil industry, we believe that it would be helpful at the outset briefly to indicate the theory of the depletion allowance and the standards which govern its application. We shall then show that, under these standards, the taxpayers did not acquire, by investment, any economic interest in the coal in place. On the contrary, they had only the "mere economic advantage derived from production, through a contract-

ual relation to the owner," that is enjoyed by any employee or independent contractor who is employed to perform a particular task in return for a stated compensation, but who has "no capital investment in the mineral deposit" (*Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 367).

A. THE DEPLETION DEDUCTION IS DESIGNED TO PERMIT THE TAX-FREE RECOVERY OF A CAPITAL INVESTMENT IN A WASTING ASSET WHICH IS EXHAUSTED THROUGH EXTRACTION. IT IS NOT INTENDED TO PROVIDE AN INCENTIVE FOR THE DEVELOPMENT OF MINERAL RESOURCES, OR TO COMPENSATE FOR RISKS INHERENT IN THE MINING INDUSTRY.

The "fundamental purpose of the statutory allowance" for depletion is to provide "compensation to the owner for the part" of "wasting" "mineral deposits" which are "used up in production" (*Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 366). It is "based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit" (*Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 312), and is allowed "as compensation to the owner for the part used up in production" (*Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 366). It is "designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired" (*Southwest Exploration* case, *supra*, p. 312). Since "gross income from mining" is taxed as ordinary income rather than as a capital gain (*Burnet* v. *Harmel*, 287 U.S. 103), the depletion allowance thus serves the same purpose of permitting a tax-free recovery of the raw material (the mineral)

as the deduction in manufacturing of the cost of the raw material as part of the cost of the goods sold. It is analogous to the depreciation deduction allowed for tangible physical assets used in a taxpayer's trade or business. See *United States* v. *Ludey*, 274 U.S. 295, 302–303.

Initially, the depletion allowance was based on the taxpayer's capital investment in the mineral, and then on the value of the mineral in place. See *Helvering* v. *Twin Bell Syndicate*, 293 U.S. 312, 315–319. However, in 1926 Congress adopted the present system of "granting an arbitrary deduction * * * of a percentage of gross income * * *" (*Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 367). While "[t]he present allowance * * * bears little relationship to the capital investment, and the taxpayer is not limited to a recoupment of his original investment" (*Commissioner* v. *Southwest Exploration Co.*, *supra*, p. 312), this fact "in no way altered the fundamental theory of the allowance," namely, that it is "compensation to the owner for the part" of his "capital investment in the mineral deposit" which is "used up in production" (*Bankline* case, *supra*, pp. 366–367, 368).

Petitioners are thus in error in contending that the purpose of the depletion allowance is to "stimulate the development of natural resources and compensate the operator for the risks inherent in his business" (*Parsons* Br. 13), or to "stimulate prospecting, exploration and production of minerals" and provide a "reward * * * for the assumption of the inherent risks of discovery and extraction" (*Huss* Br. 15, 16; see Schumacher *amicus curiae* Br. 7). The element

of risk in a particular transaction is provided for by the parties in the price which they set. For example, in these cases the prices paid by Rockhill and Reading reflected various risk factors, including the possibility that, upon removing the overburden, marketable coal might not be recoverable. See No. 218, R. 16; No. 305, R. 33. The fact that some extractive industries are more risky than others is reflected in the varying percentages of gross income which are allowed for depletion. Compare the 27½ per cent allowed for oil and gas depletion with the lower rates for minerals. Internal Revenue Code of 1939, Sections 114(b)(3) and (4). But "[t]he depletion deduction * * * is *not* to be construed * * * as a reward to those persons who actually mine the coal for the risks inherent in extraction. In common with industry generally those engaged in extraction of minerals on a for-hire basis receive their tax benefit through depreciation and obsolescence allowances, and not through an allowance for the depletion of the mineral deposit on which they happen to be working." *Usibelli* v. *Commissioner*, 229 F. 2d 539, 541 (C.A. 9) (emphasis in original; footnote omitted).

B. IN ORDER TO OBTAIN A DEPLETION ALLOWANCE, A TAXPAYER MUST HAVE A CAPITAL INVESTMENT IN THE MINERAL IN PLACE. A MERE ECONOMIC ADVANTAGE DERIVED FROM PRODUCTION IS NOT SUFFICIENT

In *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, this Court recently pointed out (p. 313) that, "[i]n determining which parties are entitled to depletion," it "has relied on two interrelated concepts which were first formulated in *Palmer* v. *Bender*, 287

U.S. 551." It stated (p. 314) that *Palmer* held that "a taxpayer is entitled to depletion where he has:

> (1) 'acquired, by investment, any interest in the oil in place,' and (2) secured by legal relationship 'income derived from the extraction of the oil, to which he must look for a return of his capital.' "

and that

> [t]hese two factors, usually considered together, constitute the requirement of "an economic interest."

Palmer v. *Bender* held that the owners of oil and gas leases, which they transferred to oil companies in return for bonuses and future royalties, were entitled to depletion thereon. The Court pointed out (p. 558) that the owners of the leases acquired "complete legal control of the oil in place" and therefore "acquired an economic interest in it which represented their capital investment and was subject to depletion under the statute";[8] that when the lease owners transferred their operating rights thereunder to the oil companies "they retained, by their stipulations for royalties, an economic interest in the oil, in place, identical with that of a lessor"; that "throughout their changing relationships with respect to the properties, the oil in

[8] In *Lynch* v. *Alworth-Stephens Co.*, 267 U.S. 364, the Court previously had held that a lessee of iron ore lands was entitled to depletion. The Court stated (p. 369) that although the leases "did not convey title to the unextracted ore deposits," they did create a "very real and substantial interest therein" which "is property," namely, they gave the lessee "the exclusive possession of the deposits and the valuable right of removing and reducing the ore to ownership * * *."

the ground was a reservoir of the capital investment of the several parties"; and that "[p]roduction and sale of the oil would result in its depletion and also in a return of capital investment to the parties according to their respective interests."

The issue in *Palmer* v. *Bender,* therefore, was not whether the taxpayer had *acquired* an economic interest in the oil in place (since it was clear that it had done so by acquiring the lease), but whether, by reservation of royalties upon transfer of the lease, it had *retained* such an interest. The case accordingly affords no support to petitioners, since the issue here is not whether they retained an economic interest in the coal in place, but whether they acquired such an interest in the first place.

Most of the subsequent decisions by the Court in this field, including *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25, upon which *Huss* relies (Br. 11), similarly involved the question whether the particular interest retained gave the transferor or assignor an economic interest in the oil in place. Those decisions, therefore, did not involve the issue in the instant cases—whether there was an initial acquisition of an interest in the mineral in place—since in those cases the transferors "once had at least a fee or leasehold in the oil-producing properties themselves" (*Commissioner* v. *Southwest Exploration Co.,* 350 U.S. 308, 315). The issue in those cases was whether the second criterion for an "economic interest" was satisfied—that is, whether the receipt of further income by the transferor was dependent solely on production, so that only

the mineral itself could be looked to as the source for recovery of that part of the original capital investment that was represented by the retained interest. They include such cases as *Thomas* v. *Perkins*, 301 U.S. 655, *Anderson* v. *Helvering*, 310 U.S. 404, and *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599. But even in those cases the Court reiterated the basic criterion of a capital investment in the mineral in place. For example, in *Kirby*, it stated (p. 603) that

> The test of the right to depletion is whether the taxpayer has a capital investment in the oil in place which is necessarily reduced as the oil is extracted.

and (p. 606) that

> a share in "net profits," disassociated from an economic interest, does not entitle the holder to a depletion allowance.

In two cases in which a depletion allowance was denied, the Court drew the distinction, which we believe is crucial in the cases at bar, between an "economic interest" in the mineral in place and a mere "economic advantage" unaccompanied by any interest in the mineral. In *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, the Court held that a processor of gas was not entitled to a depletion deduction on the basis of its agreement to purchase gas at the well head, since it had no economic interest in the gas in place. It stated (pp. 367, 368):

> * * * the phrase "economic interest" is not to be taken as embracing a mere economic advantage derived from production, through a contractual relation to the owner, by one who

> has no capital investment in the mineral deposit. * * *
>
> * * * * *
>
> Undoubtedly, respondent through its contracts obtained an economic advantage from the production of the gas, but that is not sufficient. The controlling fact is that respondent had no interest in the gas in place. Respondent had no capital investment in the mineral deposit which suffered depletion and is not entitled to the statutory allowance.

In *Helvering* v. *O'Donnell*, 303 U.S 370, the taxpayer sold one-third of the stock of an oil company (San Gabriel), in return for one-third of the net profits from the operation of the oil and gas properties of San Gabriel, which the purchaser of the stock agreed to acquire. The Court held that the taxpayer was not entitled to a depletion deduction on his share of the net profits. It stated (p. 372):

> As consideration for the sale of his stock in the San Gabriel Company respondent bargained for and obtained an economic advantage from the Midway Company's operations but that advantage or profit did not constitute a depletable interest in the oil and gas in place.

In *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, this Court for the first time allowed depletion to a party who, prior to the transaction involved, had had no fee or leasehold interest in the mineral. There Southwest was a lessee under a State lease which entitled it to extract offshore oil belonging to California. The oil was produced by slant drilling operations conducted from upland property, configuous to the

offshore oil, not owned by Southwest. California permitted offshore oil drilling only from the contiguous uplands; Southwest did not have any interest in such lands. In return for permitting it to drill on the uplands, Southwest agreed to pay the uplands owners a share of the net profits of the operation.

This Court held that the upland owners were entitled to depletion on their share of the net profits from the operation. Pointing out (p. 315) that without the participation of the upland owners "there could have been no bid, no lease, no wells and no production," it held that since the upland owners were "essential parties" to any drilling operations (p. 316) and had made "an indispensable contribution" to the production of oil (p. 317), their "contribution [the use of their land] was an investment in the oil in place sufficient to establish their economic interest" (p. 316). It "decide[d] only that where, *in the circumstances of this case,* a party essential to the drilling for and extraction of oil has made an indispensable contribution of the use of real property adjacent to the oil deposits in return for a share in the net profits from the production of oil, that party has an economic interest which entitles him to depletion on the income thus received" (p. 317, emphasis added).

In effect, the Court in *Southwest* assimilated the position of the uplands owners to that of a lessor. Realistically, the uplands owners had the same degree of control over the exploitation of the oil deposits as a lessor has over mineral lands which he leases. Since California law in effect made the uplands an integral part of the oil deposit (for, without such lands,

the oil could not be extracted), the uplands owners already had an economic interest in the oil at the time they granted the taxpayer the right to use their land for drilling. When they did so, they yielded control over the mineral; but they retained the same kind of economic interest in the oil in place that a lessor of mineral lands retains when he leases them.

In the instant cases, however, Parsons and Huss had no control of the coal prior to their stripping contracts with the coal companies. They were neither "essential" to the extraction of the coal, nor did they make any "indispensable contribution" of land or otherwise. For, unlike the situation in *Southwest*, where without the right to use the uplands Southwest could not have obtained the lease on the offshore oil deposits, in the cases at bar the coal companies could either have removed the coal themselves, or hired some other contractor to strip mine the tracts.

In sum, the test of the right to depletion (assuming that the income is derived solely from production of the mineral, as is the case here) is whether the taxpayer has a capital investment in the mineral in place, or merely an economic advantage derived from production. That standard also is reflected in Treasury Regulations 111, Section 29.23(m)–1 (Appendix, *infra*, pp. 42–44). While in some of this Court's decisions the crucial issue was whether the taxpayer's income was derived solely from production, these were cases in which the original capital interest in the mineral in place was clear. As we shall now show, in the instant cases the taxpayers acquired no interest, legal or other, in the mineral in place, invested no capital there-

in, and therefore did not have the requisite economic interest to justify a depletion allowance.

C. PETITIONERS HAD NO CAPITAL INVESTMENT IN THE COAL IN PLACE; THEY HAD MERELY AN ECONOMIC ADVANTAGE DERIVED FROM PRODUCTION

In determining whether particular taxpayers had the necessary "economic interest" in the mineral in place to entitle them to a depletion allowance, this Court has looked to the "fundamental purpose of the statutory allowance" (*Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 366) of "permit[ting] a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired" (*Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 312).[9] The inquiry here, therefore, is whether petitioners had "a capital investment in the [coal] in place which is necessarily reduced as the [coal] is extracted." (*Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, 603). We submit that the courts below correctly answered this question in the negative. For neither Parsons nor Huss had any "economic interest" in the coal in place; they had only "a mere economic advantage derived from production, through a contractual relation to the owner," similar to that of any independent contractor "who has no capital investment in the mineral deposit" (*Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 367).

1. One who contracts to perform services in connection with the extraction of minerals does not

[9] See, also, *Palmer* v. *Bender*, 287 U.S. 551, 557–558; *Herring* v. *Commissioner*, 293 U.S. 322, 325–328.

acquire an economic interest in the minerals in place merely because the compensation is based upon the volume of mineral extracted, or because he furnishes substantial equipment and supplies for the job. In order to obtain depletion, the arrangements between the parties must be such that the payments were not merely compensation for the performance of an employment contract, but represented in part a return of the stripper's capital investment in the mineral in place, which is being depleted by extraction.

Apart from the situation where the stripper has an ownership interest in the coal, as in the case of a lessee or one who has the right to sell the coal for his own account, we submit that a stripper cannot have an economic interest in the coal in place where he does not have the right to remove a substantial and significant portion of that coal. To obtain an economic interest in the coal in place, a stripper must at least have the right (1) to mine all or a substantial portion of the tract, (2) to extract a substantial number of tons of the mineral, or (3) to continue stripping operations for a sufficient time so that he can be certain of being able to remove a substantial amount of coal. See G.C.M. 26290, 1950–1 Cum. Bull. 42. For otherwise there is no real nexus between the stripper's capital investment and the mineral in place.

Necessarily, the stripper does not have such a right in relation to the mineral if the coal owner can terminate the contract without cause on short notice. For a stripper's right to extract coal, assuming that it otherwise meets the test of substan-

tiality, is illusory if subject to immediate termination without cause. He is, by analogy to real property law, only a tenant at sufferance, subject to removal at any time and for any reason by the coal owners. In these circumstances, the stripper cannot be said to have any real capital investment in the coal in place; he has merely an employment contract under which he can continue to work as long as the coal company is satisfied with his services.

It is well settled in other areas of tax law that the existence of an absolute right of termination may preclude the vesting of rights and obligations which might otherwise exist. For example, an *inter vivos* transfer of property with a retained right to revoke the transfer leaves the transferor taxable on the income from the transferred property, just as though he owned the property. See Sections 166 and 167 of the Code (26 U.S.C. 1952 ed., Secs. 166 and 167). The right to revoke a purported gift prevents the transfer from being a completed gift for gift tax purposes. *Burnet* v. *Guggenheim,* 288 U.S. 280. Similarly, if there exists the power to revoke or terminate an *inter vivos* transfer, there has not been a sufficient transfer of the property to exclude it from the transferor-decedent's gross estate for estate tax purposes. See Section 811(d)(1) of the Code (26 U.S.C. 1952 ed., Sec. 811); *Commissioner* v. *Estate of Holmes,* 326 U.S. 480. The reason for attaching significance to the right to revoke, of course, is simply that for all practical purposes the rights otherwise conferred, or the obligations otherwise assumed, may be disregarded when they can be nullified at any time. This

principle is no less applicable in the depletion field than in other tax fields.

As long as the coal company has the right to terminate without cause on minimal notice, it is immaterial whether that right ever was exercised. For in determining whether the stripper acquired an economic interest in the coal in place, the crucial factor is what the relationship was when the stripping arrangements were made. Since the right to terminate at will is inconsistent with the concept of any real interest in the coal in place, the requisite economic interest could not subsequently come into being *nunc pro tunc* because the coal company did not exercise its rights of termination.

Similarly, it is beside the point whether, as *Huss* states (Br. 12), the termination provision was inserted in its contracts solely to enable the coal company to discharge an unsatisfactory operator. For as long as the coal company has the absolute right to terminate, the reasons which led it to insist upon that right are immaterial. On their face, the Huss contracts unqualifiedly permitted Reading to terminate without cause; and it is not disputed that, whatever may have been the reasons for inclusion of that provision, Reading at any time could have terminated Huss' services if it became dissatisfied with them.

The *Parsons* taxpayers are in error in arguing (Br. 18–19) that a termination clause merely affects the value of the stripper's interest. Of course, it does affect the value of whatever interest the stripper has; but it also determines the extent of that interest and its relationship to the coal in place. A power to

terminate the contract, being essentially a power to revoke all rights and obligations as to the stripper, makes the contract only a terminable contract of employment and precludes the stripper from acquiring any interest in the coal in place.

The *Parsons* taxpayers also suggest (Br. 16–17) that the terminability of a strip mining contract is without significance because in *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308, the contracts of the upland owners, who were held to have an economic interest in offshore oil in place, were also terminable. But there termination of the agreements would also have caused termination of the production of the offshore oil. The upland owners' interests were, for all practical purposes, co-terminous with the production of the offshore oil. Hence, in that case there was present what is lacking here: a substantial nexus between the taxpayer's capital investment and the mineral in place. In contrast, the termination of a strip mining contract does not necessarily stop the extraction of coal; it permits the coal company to bring in a new contractor to continue the operation, or to perform the work itself.

We reiterate the basic proposition that, in order to be entitled to a depletion allowance, the taxpayer must have an interest in the mineral *in place*. A mere interest in the mineral after it has been extracted is not enough; for only if the interest is in the mineral in place can it be said that the taxpayer's capital is being exhausted as the mineral is depleted.

Thus, contrary to taxpayers' assumption (*Huss* Br. 11, 16; *Parsons* Br. 12, 13, 22), the question is not

whether they made an "investment" in connection with their strip mining contracts, or what the amount of such investment was. Concededly, Parsons and Huss made an investment in their strip mining operations. But this was no more than the normal investment which an independent contractor ordinarily makes when he is employed to do a job. The same kind of investment would be made by someone engaged in excavating, razing or, as Parsons had done prior to the instant contracts with Rockhill, in road building. But such an investment, without the concomitant right to remove a substantial amount of the mineral, does not create an interest in the mineral in place. The distinction is that drawn by this Court in *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, between an "economic interest," which represents a capital investment in the mineral in place, and a mere "economic advantage derived from production" which is insufficient to justify depletion (see *supra*, pp. 27–28).

Since it is clear that both Rockhill and Reading had the absolute right to terminate the strippers' contracts on minimal notice (see *supra*, pp. 5, 6, 11), we submit that the strippers did not acquire any economic interest in the coal in place by virtue of their strip mining agreements. The lower courts, including the court below in these cases (No. 218, R. 36–37; No. 305, R. 68–69), have generally taken this position. *Commissioner* v. *Mammoth Coal Company*, 229 F. 2d 535 (C.A. 3), certiorari denied, 352 U.S. 824; *Stilwell* v. *United States*, 250 F. 2d 736 (C.A. 4); *Usibelli* v. *Commissioner*, 229 F. 2d 539 (C.A. 9); *Clifton* v. *Commissioner*, decided April 21, 1958 (1958 P–H T.C.

Memorandum Decisions, par. 58,065); *Morrisdale Coal Mining Co.* v. *Commissioner,* 19 T.C. 208; *Fink* v. *Commissioner,* 29 T.C. 1119, now pending on appeal to the Third Circuit; *C. A. Hughes & Co.* v. *Commissioner,* decided March 9, 1955 (1955 P-H T.C. Memorandum Decisions, par. 55,051); see also, G.C.M. 26290, *supra.*[10]

2. But assuming *arguendo* that the coal owners' right to terminate without cause does not itself preclude the existence of an economic interest in the coal in place, there is an additional reason why the taxpayers are not entitled to depletion. In *Southwest,* this Court stated that to have the requisite "economic interest" for depletion, a taxpayer must have "acquired, by investment," an interest in the mineral in place (350 U.S. 308, 314). It is difficult to see how Parsons and Huss made any capital contribution which would constitute such an investment. As the court below pointed out in *Huss* (No. 305, R. 69), the kind of capital outlays which the strippers here made appear indistinguishable "from capital expenditures normally made by independent contractors who undertake large projects in such familiar fields as road building and general construction." The taxpayers could recover the cost of the equipment which they furnished through depreciation deductions or on

[10] While the Fourth Circuit at one time deemed the existence of the right to terminate immaterial (*Weirton Ice & Coal Sup. Co.* v. *Commissioner,* 231 F. 2d 531, 534-535; *Commissioner* v. *Hamill Coal Corp.,* 239 F. 2d 347), its most recent decision in this field stated: "A most important factor is the terminability of the taxpayer's rights" (*Stilwell* v. *United States,* 250 F. 2d 736, 739).

a sale;[11] the cost of the services which they supplied was deductible, and thus recoverable tax-free, as ordinary and necessary business expenditures (Internal Revenue Code of 1939, Section 23(a)); and, moreover, there was no indication that the equipment which they used was so uniquely designed for these particular projects as to preclude its use elsewhere[12]—a factor which might indicate that there had been a capital investment in the mineral. Furthermore, the strippers' organization and skill obviously did not diminish in value through their employment on these jobs; if anything, they became more valuable through experience.

Parsons and Huss had no right to exploit the coal

---

[11] Section 23(l) of the Code (26 U.S.C. 1952 ed., Sec. 23) provides for a deduction in the amount of "A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) * * * of property used in the trade or business" and the annual deduction therefor is normally taken on the adjusted cost basis of the property (see Sections 113(a) and (b)(1) and 114(a) (26 U.S.C. 1952 ed., Secs. 113 and 114)). If the property is sold, the cost thereof, as adjusted for depreciation and other factors, is excluded in computing gain or loss. (See Sections 111(a) (26 U.S.C. 1952 ed., Sec. 111), and Section 113(a) and (b)(1).

[12] The District Court found in *Huss* (No. 305, Fdgs. 20, 21, R. 32) that the equipment which Huss originally used on the Reading job was "not acquired solely for that contract"; that, except for one machine, all of the approximately $500,000 worth of equipment which Huss had on the job by the end of 1947 "had been used on other coal stripping contracts not with Reading"; and that at the end of 1947 Huss' "equipment was either moved on to other properties or sold." In *Parsons*, as the Court of Appeals pointed out (No. 218, R. 36), there was similarly "no indication that the partnership equipment had utility only for this [Rockhill] job or was specially adapted to it."

on their own account; they could not keep or sell any part of it.[13] Their sole right was to remove the coal and turn it over to the coal companies in return for a stated price per ton. On their face, and in actual operation, the strip mining agreements were no more than ordinary employment contracts, by which Parsons and Huss strip mined coal under what, in effect, was a piece-work method of compensation.

3. Under Section 23(m) of the Internal Revenue Code of 1939, the depletion allowance must be "equitably apportioned between the lessor and lessee" of mineral property. Percentage depletion is allowed, under Section 114(b) of the Code, on the "gross income from the property" and, in the case of mines, is limited to five percent of such income. To the extent that the strip miner is allowed a depletion deduction, there must be a corresponding disallowance of the deduction to the owner of the property. See *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 309.[14] The statutory provisions for depletion "must be read in the light of the requirement of apportionment of a single depletion allowance" (*Helvering* v. *Twin Bell Syndicate*, 293 U.S. 312, 321).

A pertinent inquiry in these cases, therefore, is whether the mine owners, by their contractual arrangements with the strippers, fairly can be said to have

[13] Compare the contrary situation in *North Range Mining Co.* v. *Commissioner*, 46 B.T.A. 296, where a firm which undertook to mine a certain amount of iron ore for the lessee of iron mines could sell excess ore for its own account.

[14] Section 114(b)(4) excludes from the gross income from mining which is subject to depletion "an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property."

given up a part of their ownership of the coal in the ground, so that a portion of their depletion allowance should be shifted to the contractors. To put the question in these terms is to answer it. For we think it clear that the mine owners have not given up any part of their ownership of the coal by permitting the strippers to mine it pursuant to arrangements under which the owners retained the right to terminate the operation at will, and the strippers had no right to dispose of the coal except to them. The arrangements did not result in any transfer of the coal companies' ownership of the coal in place to the strippers; and the strippers did not acquire any economic interest in such coal, but only the economic advantage which any independent contractor has in the "subject matter with which he is to work for an agreed price" (No. 218, R. 36–37).

CONCLUSION

The judgments of the Court of Appeals, sustaining the denial of depletion allowances to petitioners, should be affirmed.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.
CHARLES K. RICE,
Assistant Attorney General.
DANIEL M. FRIEDMAN,
Assistant to the Solicitor General.
MARVIN M. WEINSTEIN,
Attorney.

FEBRUARY 1959.

APPENDIX

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions

* * * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

For percentage depletion allowable under this subsection, see section 114(b), (3) and (4).

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) [as amended by Sec. 145, Revenue Act of 1942, c. 619, 56 Stat. 798, and Sec. 124 (a) and (c), Revenue Act of 1943, c. 63, 58 Stat. 21] *Basis for Depletion.*—

* * * * *

(4) *Percentage depletion for coal* * * *

(A) *In General.*—The allowance for depletion under section 23(m) shall be, in the case of coal mines, 5 per centum * * * of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

* * * * *

(B) *Definition of Gross Income from Property.*—As used in this paragraph the term "gross income from the property" means the gross income from mining. * * *

(26 U.S.C. 1952 ed., Sec. 114.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.23(m)–1. *Depletion of Mines, Oil and Gas Wells, Other Natural Deposits, and Tim-*

ber; Depreciation of Improvements. Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

* * * * *

When used in these sections (29.23(m)–1 to 29.23(m)–28, inclusive) covering depletion and depreciation—

* * * * *

(c) The term "mineral deposit" refers to minerals in place. * * *

* * * * *

(f) "Gross income from the property," as used in section 114(b) (3) and (4) and sections

29.23(m)–1 to 29.23(m)–28, inclusive, means the amount for which the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine or well, but, if the product is transported or processed (other than by the processes excepted below) before sale, it means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade before such transportation or processing. * * *

* * * * * *

U. S. GOVERNMENT PRINTING OFFICE: 1990